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Perestroika, Prices, and the Ruble Problem

by Padma Desai

Economic reforms under *perestroika* have proceeded at a cautious pace that disappoints many impatient Western observers and some articulate economists in the Soviet Union.

Yet the slowness of economic reform, compared to the speed of political reform, is a sensible strategy.[1] This is especially so in light of recent events in China, where the opposite approach was undertaken. By immediately responding to the Soviet people's political and cultural aspirations, *glasnost'* has bought the leadership time to implement demanding economic reforms. It has even produced indirect economic benefits via arms control (in reduced defense spending) and improved foreign relations (in increased flow of credits).

Besides, economic reforms have continued moving forward. General Secretary Gorbachev crossed a watershed when he presented the new farm policy in mid-March of 1989. At that time, he took a measured step towards reforming Soviet agriculture by announcing that any of the USSR's 50,000 state and collective farms could reorganize itself as a cluster of households, in turn leasing land from the farm.[2]

But the actual gains from *perestroika* have been small. More importantly, progress on price reform is stalled. It is now clear that economists and reformers were slow to appreciate how the price system works and what it accomplishes in market economies.[3]

Even at the beginning, though, there was intuitive recognition that persistent shortages of desired goods and inventories of unwanted commodities were the result of centralized directives. The notion that flexible prices would, at minimum, enable the system to reduce these problems is now generally accepted.

But the reformers are afraid to take steps in the direction of flexible prices. They are concerned that freeing prices would raise them and create consumer unrest, thereby complicating life for *perestroika*'s proponents and jeopardizing its success. So price flexibility has not advanced beyond the *kolkhoz* markets where agricultural produce is sold at market prices. A recent decree[4] has placed limits on the traditional practice of enterprises charging higher prices on new products, as well as on the initial freedom cooperatives were given to set their own prices.

On the whole, the price regime continues to be "cost-plus" prices set by the state's Price Committee. Price reform implies that the market must gradually take over the functions of the Price Committee; prices must result from market signals.

Perhaps price reform could have progressed more rapidly. But an altogether new element has emerged on the scene in the past three years. President Gorbachev must now confront a new set of problems which present the potential for creating destabilizing inflation. Relieving this underlying macroeconomic malaise is critical to the success of his program to achieve microeconomic efficiency by providing market signals to the farms and the factories. Price reform,

1 The strategy underlying the reform process is argued at considerable length in Padma Desai, *Perestroika in Perspective: The Design and Dilemmas of Soviet Reform* (Princeton: Princeton University Press, 1989).

2 The farm policy reform announced by Gorbachev fell short of the Chinese reform which, by 1984, had abolished almost all communes. In Padma Desai, "Soviet Farm Plan: Gorbachev Takes Chinese Lessons," *Wall Street Journal*, March 27, 1989, p. A10, the soundness of the Soviet strategy, in light of the lessons of the more sweeping Chinese reforms, is argued. In a recent dramatic move, the leadership has promised the farms foreign exchange on their sale of extra output beyond the levels of the early 1980s.

3 For a detailed justification of this view, see Desai, *Perestroika, op. cit.*, Chapter 5 and Appendix 1. This is not surprising, since familiarity with the role of the price mechanism was lacking among economists who had been brought up in an overly-planned regime.

4 *Pravda*, February 4, 1989.

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without prior remedial measures, could result in macroeconomic crisis instead of microeconomic efficiency.

Different Types of Shortages

At the outset, a distinction must be made between localized (or sectoral) shortages and generalized (or economy-wide) shortages.

When one walks down a Moscow street and sees a long line for sugar, or reads about backlogs of orders for automobiles, these may indicate merely that the suppliers have underproduced these specific commodities (while presumably overproducing others). The market demand for these items, at the "administered," fixed prices, exceeds their supply. But these experiences could also signal shortages that are more pervasive. One may think that there are shortages of commodities here and there when, in fact, the demand exceeds the supply for almost everything that consumers and investors want.

The former problem, localized shortages at fixed prices, has long been known to occur under central planning. Early advocates of centrally planned economies assumed perfect foresight — planners would have no problem matching production to demand. It has not worked out that way. Centrally planned economies have faced the "ill-fitting jigsaw puzzle" problem. At fixed prices and centrally determined production quantities, supply and demand frequently do not match. Desired goods are often scarce, while undesired goods pile up. There is, in economic jargon, "micro-disequilibrium."

In the case of generalized shortages, however, the problem is different. At the fixed prices, many goods are in scarce supply. The flip side of this phenomenon is that those who wish to spend money and buy more goods at the fixed prices are unable to do so; there is frustrated, pent-up, excess demand. If prices were allowed to rise, inflation would result. Prices would go up and absorb the desired increment in spending. With fixed prices, there is instead "repressed inflation." Shelves are empty, lines are long and those who wish to buy more are instead compelled to save.

Additionally, there are two types of generalized shortages. The shortages may be truly economy-wide and extend to all sectors, including investment goods. The economy is generally "overheated," but the universal price rigidity leads to widespread lines and empty shelves for consumer goods, and to backed-up orders for investment goods. There are generalized shortages everywhere.

The other type, however, is more pertinent in the traditional Soviet context: the generalized shortages may be manifest only in consumer goods markets. That is, the phenomenon is one of generalized consumer-goods shortage. This is the implicit assumption of some of the economists who analyzed the problem of repressed inflation in centrally planned economies in the 1970s.[5] Their models imply that the markets for investment and defense items will be given priority, with demand matching supply at the fixed prices. Excess demand and repressed inflation therefore will be concentrated exclusively in consumer goods markets. Moreover, if governmental demands for consumption (for example, soap in Kremlin washrooms) are assumed to be automatically satisfied on a priority basis, there will be "frustrated" or unsatisfied spending on consumer goods in the household sector.

Households, in other words, will be forced to save. The total observed savings in the economy will equal the sum of voluntary savings in all sectors (i.e. in the government budget, enterprises and households) and involuntary savings in the household sector. Households are the only source for involuntary savings.

The Budget Deficit and the Ruble Overhang: The Current Predicament

What is the role of the budget in all this?

A budget surplus contributes to savings in the economy. By contrast, a budget deficit implies that the budget is a source of dissaving. When the government dissaves (runs a deficit), *Gosbank* (the state bank) prints rubles to accommodate the excess expenditure. The rest of the economy must do the extra saving to offset the dissaving of the government if inflation is to be avoided. If Soviet households do not provide this extra saving voluntarily, they will create excess demand for consumer goods. But given the fixed prices, the stores cannot absorb the desired excess spending with their available supply. The households will thus do the extra saving involuntarily — they have no other option. There will be "repressed inflation." The recent rise in the Soviet budget deficit has therefore created, or accentuated, this problem.[6]

Along with mounting budget deficits, an institutional practice, typical of the Soviet system, has created a serious problem for Gorbachev and *perestroika*. The Soviet people have accumulated their stock of savings to date in the form of extremely liquid assets. State ownership of the means of production has implied that the public can keep its rubles

5 The important contributions to this discussion are: George Garvey, "Inflation and Price Stabilization Policies in Some East European Countries," and "Stabilization Policy and Monetary Equilibrium," both in *Anti-Inflationary Policies: East-West*, Proceedings of Tenth International Seminar, Venice, August 1974; Franklyn Holzman, "Soviet Central Planning and its Impact on Foreign Trade Adjustment Mechanism," in A. Brown and E. Neuberger, eds., *International Trade and Central Planning*, (Berkeley: University of California Press, 1968); and Gertrude Schroeder, "Consumer Goods Availability and Repressed Inflation in the Soviet Union," in *Economic Aspects of Life in the USSR* (Brussels: NATO, 1975).

6 For decisive statements of this view, see Abram Bergson, "Cutting Deficit Is Political Loser Even for Soviets," *Wall Street Journal*, April 17, 1989, p. A10, and "Spirits Are High for Soviet Economy," *Wall Street Journal*, June 1, 1989, p. A11.

only in the form of cash or bank deposits. If flexible pricing were introduced, and prices of important consumer goods began rising, the result could be a volatile "dishoarding" of cash and deposits. Such a dramatic increase in spending would raise prices and could even unleash a price spiral under which prices increase continually.

This is the "ruble overhang" problem. It has to be distinguished from the problem of "involuntary savings" that the recent expansion of the Soviet budget deficit has brought to the fore. (In jargon, the ruble overhang is a stock phenomenon; the current budget deficit is a flow phenomenon.) The combination of the two has created the economic difficulty in which the Soviet planners find themselves. Their predicament is this: Given the considerable, accumulated stock of cash and deposits in the hands of the public, and the recent expansion of the Soviet budget deficit, price reform in the form of price flexibility would be perilous. Instead of bringing about orderly relative price changes leading to improved resource allocation, price reform would unleash general price increases and could even trigger an inflationary spiral.

Sooner or later, *perestroika* needs price reform. But it cannot be undertaken prudently until the twin problems of the ruble overhang and the hugely expanded budget deficit are first brought under control. In order to do this, the planners must correctly assess the current situation and its underlying causes.

The Situation Before *Perestroika*

That the Soviet Union has long had localized shortages of consumer goods because supplies do not match demands under rigid central planning is almost a cliché. The controversial question has been whether the economy has also long been characterized by generalized shortages of consumer goods. Can it be that for a long spell during the Brezhnev years, for example, the desired consumption of the public from their take-home pay was in excess of the available supplies of consumer goods, leading to involuntary savings and repressed inflation?

After the Second World War, several devastated countries of Europe went through a sustained period, up to a decade long, during which price controls were maintained on scarce consumer goods. Such repressed inflation implied that their governments were using involuntary savings to "finance" increased investment levels and rebuild their economies. In Great Britain, for instance, the long period over which this policy was maintained led to a well-known critique by Sir Roy Harrod in his book *Are These Hardships Necessary?*

The question for the Soviet Union (and the other centrally planned economies of Eastern Europe) has been whether this is an endemic and enduring feature. The innumerable jokes about lines, and the occasional sight of *babushki* with bags in hand outside shops, added up to the impression that these economies were marked by generalized shortages of consumer goods.

But appearances can be deceiving. Statistical analysis during the mid-seventies suggested that the average rate of personal savings by Soviet households was close to 1.5 percent for 1955-1965, rising to more than twice that during the late sixties and over five percent during the late seventies. Even at its peak, this rate of saving hardly looks as though it conceals a significant amount of involuntary saving. Nor is it excessive in comparison to other countries.[7]

It must be noted, however, that the average propensity to save for all households hides a much higher average propensity to save in some households which may well be constrained into involuntary saving. Thus, recent data suggest that Soviet savings deposits are heavily concentrated in a few households: three percent of the population holds fifty percent of these deposits. Only one out of eight Soviet citizens does any saving at all.[8]

The hypothesis that, despite the "reasonable" average savings rate for aggregate households there has been some involuntary saving in the Soviet economy in the pre-*perestroika* period, cannot therefore be decisively dismissed.[9] On balance, however, it seems reasonable to conclude that when Gorbachev embarked on *perestroika* in 1985, the Soviet economy was characterized by localized consumer goods shortages as always, but that there was little compelling evidence of generalized consumer goods shortages and involuntary saving by Soviet households. The stock of past savings was held exclusively in the form of liquid assets, i.e. cash and bank deposits. The budget deficit was a source of dissaving, but not in any dramatic fashion: it had averaged roughly two percent of GNP during 1981-1985.

The Soviet economic "crisis" that Gorbachev inherited was not macroeconomic in character but microeconomic. The Soviet growth rate had fallen sharply, reflecting sluggish advances in technology and diminishing returns to investment. Farms and factories needed incentives to produce, innovate and invest in an environment of efficiently functioning markets if the economy was to be turned around.

But by 1988 macro-economic disequilibrium had become an issue of importance rivaling that of efficiency. It now stands in the way of the price reform that the planners must adopt for bringing about a better use of resources. What happened?

7 *Cf.* Joyce Pickersgill, "Soviet Household Saving Behavior," *The Review of Economics and Statistics*, 58 (2), May 1976, pp. 139-47.

8 *Cf.* Central Intelligence Agency, *USSR: Estimates of Personal Income and Savings*, Directorate of Intelligence, SOV 89-10035, U.S. Government, April 1989, footnote 14, p. 6.

9 The view that Soviet household savings have been mainly involuntary is expressed with vigor in Igor Birman, *Secret Incomes of the Soviet State Budget* (The Hague: Martinus Nijhoff Publishers, 1981).

Perestroika: 1985 and Thereafter

After 1985, reduced revenues led to a substantial budget deficit. Wages drifted up in excess of productivity increases. A sharp increase in investment implied a significant reduction in the normal growth of consumer goods supplies. The combination of these three factors contributed to unprecedented involuntary savings, with the demand for consumer goods outstripping their supply. Moreover, the limited moves towards freer scope of action by enterprises under *perestroika* finally appeared to have created excess demand by enterprises for available investment goods. Given the accumulated liquid assets of cash and bank deposits among households, the result was a disturbing economic situation.

Budget Deficit

The budget deficits, two percent of GNP on average during 1981-1985, jumped sharply to six percent in 1986 and came close to eight percent in 1987 and 1988.[10] The planned deficit of 100 billion rubles for 1989 would lead to a deficit of eleven percent.[11] The U.S. budget deficit currently runs at about three percent.

The problem has been more with revenues than with outlays. The official data do not reveal a sharp departure in the growth of total outalys and their key components in 1985-1987 from their growth in 1981-1984.[12] Thus the outlays allotted to the three main categories — the national economy, social and cultural expenditures, and defense — are steady at fifty-five to fifty-seven percent, thirty-three percent and five percent respectively in both periods.

A word of caution is in order here: classifications in the Soviet budget hide more than they reveal. Outlays for the national economy include investment and (presumably) state consumption subsidies on food and other items. They also conceal military hardware procurement. Social and cultural expenditures include outlays for education and science, and pension payments. They also hide military-related research and development. What the budget calls "defense" is therefore only a fraction of what Western budgets would include under this rubric. It consists only of wages and salaries of army personnel, the supplies of food and uniforms for their use, and military construction expenditures. In late May, Gorbachev startled non-experts by revealing that, at 77.3 billion rubles, the true 1989 defense allocation was nearly four times that under the "defense" category in the budget. The experts had known this all along and, by CIA estimates, Gorbachev still may not be coming clean.

The budget revenues, unlike budget outlays, grew steadily only up to 1985. They have remained at the 1985 level since. Turnover tax revenues declined substantially from 1984 to 1987, mainly because alcohol tax receipts declined from forty-four billion rubles in 1984 to about thirty-two billion rubles in 1987.[13] The anti-alcohol campaign, spearheaded by a cut in state production of liquor, had the all-too-predictable results: an undiminished propensity to booze, flourishing bootlegging and a decline in state revenues.

Yet another casualty in the post-1985 years has been the revenues from trade taxes. The decline in world oil prices has cut state revenues from oil exports by narrowing the gap (accruing to the treasury) between foreign and domestic prices. The cutback in imports of consumer goods in 1986 and 1987 also caused diminished revenues from taxes on these items. These shortfalls have not been offset by increased accruals to the budget from other sources.

Wages and Productivity

After 1985, most enterprises abandoned their restraint on wage increases. Average monthly cash earnings of workers and office employees grew at the average annual rate of 2.4 percent during 1981-1985, but these were more than matched by the growth of labor productivity at 3.1 percent. By contrast, 1986-1988 saw these monthly cash earnings increase annually at 4.5 percent, exceeding a growth of labor productivity of 3.8 percent.[14]

This reversal in the earlier, prudent exercise of an effective "incomes policy" was accommodated by the extension of short-term credits by *Gosbank* to the enterprises. The wage inflation, in turn, seems to have arisen from the new, if limited, reforms under which enterprises have been allowed to pay higher wages to "more productive" workers. Traditionally, a sort of incomes policy was in place because enterprises were assigned production targets and a matching wage fund to pay the workforce. Now enterprises can vary wages. According to Academician Aganbegyan,[15] the payments to workers based on unfinished construction-and-installation work have gone out of control. At the same time, the need to use monetary policy to control the resulting inflation has not been fully appreciated.

10 If the actual outlays exceed the planned outlays, as is often the case, the deficits in 1987 and 1988 would be even greater than the figures in the text. *Cf.* Central Intelligence Agency, *Sharply Higher Budget Deficits Threaten Perestroyka*, Directorate of Intelligence, SOV 88-10043, U.S. Government, September 1988.
11 *Cf.* Abram Bergson, "Cutting Deficit is Political Loser," *op. cit.*
12 *Narodnoe Khoziaistvo SSSR (Narkhoz)*, Tsentral'noe Statisticheskoe Upravlenie pri Sovete Ministrov SSSR, Moscow, 1984, p. 574 and 1987, pp. 589-90.
13 *Narkhoz*, *ibid.*
14 *Pravda*, January 22, 1989.
15 *Pravda*, February 6, 1989.

From Consumption to Investment in Production

While incomes grew and productivity lagged, the composition of output in the economy also shifted. Consumer goods yielded to a larger share of investment goods (for example, steel pipes) in total production. While gross fixed investment in the economy, in 1984 rubles, had grown annually at an average rate of 3.5 percent during 1981-1985, it had jumped by 8.3 percent in 1986, 5.7 percent in 1987 and 4.8 percent in 1988.[16] The higher growth rates of the *perestroika* period, though declining from year to year, were driven by calls for *uskorenie* (acceleration) and conquests of new technologies. By contrast, the per capita annual growth rate of consumption, in 1982 established prices, already low at 0.8 percent during 1981-1985, had actually declined by 1.5 percent in 1986, and barely grew in 1987 and 1988.[17] An ever-increasing number of items moved out of retail trade and began to be distributed via coupons, special orders and invitations to fairs.[18]

The shift away from consumption to investment goods in national production and availability was perhaps the unintended consequence of the leadership's decision at the 27th Party Congress to turn the economy around. It was occurring just as the other factors, such as higher wages, were intensifying consumer demand. Thus the imbalance between supply and demand became wider.

Consequences

The net result would have been involuntary savings matching excess demand for consumer goods at the fixed prices. Soviet prices, though, are not altogether rigid. The illegal second economy has allowed for some effective price flexibility (especially in services) even before the advent of *perestroika*. Again, the device of introducing "new" products (on which higher prices are allowed) can become a vehicle for smuggling in price rises. Excess demand can be absorbed somewhat by such price increases.

In fact, Soviet sources indicate that retail prices of consumer goods rose at 1.7 percent annually during 1986 and 1987, at twice the average rate of 0.9 percent for 1981-1985.[19] According to Central Intelligence Agency estimates, the figures may have been higher: 3.4 percent for 1986 and 2.1 percent for 1981-1985.[20] Official Soviet sources report, in a rare display of *glasnost'*, that the price index of produce in the collective farm (*kolkhoz*) markets (where anything from potatoes to pork is sold freely) rose at 2.6 percent in 1981-1985 but much more rapidly at 9.4 percent in 1986.[21]

But the main result of this imbalance between consumer demand and supply, with generally rigid prices, is to create involuntary savings and shortages. Household savings have in fact increased sharply. During 1981-1984, they had averaged 11.4 billion rubles annually. They increased to nineteen billion in 1985, twenty-two billion in 1986, twenty-four billion in 1987 and were thirteen billion in the first half of 1988.[22] It is plausible that this increase reflected involuntary savings. As for shortages, they are everybody's favorite theme — from forthright complaints to Gorbachev at the famous encounter in Krasnoyarsk last September to complaints and cartoons in newspapers. Economists, among them Vasilii Sel'yunin[23] and Nikolai Shmelev have predicted chaos if shortages are not removed — the former urging speedy reforms and the latter, massive imports. While admitting the urgency for remedial action, Gorbachev has declared that the Soviet people will not reject *perestroika* just because the stores are short of commodities. Standard of living, in his view, includes not only material items but also dignity and freedom — the gifts of *glasnost'*.

Savings, in the meantime, have accumulated in bank deposits, totaling a hefty 300 billion rubles in 1988.[24] As for cash at home, the estimates range from 90 billion rubles[25] to 240 billion rubles.[26] Dishoarding of some of this stock of rubles may well have put added pressure on consumer goods markets. Shortages seem to have intensified of late. Nikolai Shmelev recently remarked that a Moscow friend had stocked up a seven years' supply of detergent. Shortages are reported even of matches and salt.[27] Tea, generally imported from soft currency earnings and hence readily available, has also become scarce.

Evidently, people are hoarding consumer goods in anticipation of price reform and higher prices. The combination of large liquid assets and increased involuntary saving, coupled with anticipation of imminent price increases, has put the economy under serious strain.

Since 1985, moreover, there appears to have been developing an excess demand situation of sorts even for investment goods, leading to generalized shortages everywhere as distinct from generalized shortages only in consumer goods.

16 *The Soviet Economy in 1988: Gorbachev Changes Course*, a report by the Central Intelligence Agency and the Defense Intelligence Agency presented to the Subcommittee on National Security Economics of the Joint Economic Committee, U.S. Congress, April 14, 1989, p. 42.
17 *Ibid.*, p. 41.
18 *Izvestiia*, March 29, 1989.
19 *Narkhoz*, various years.
20 *USSR: Sharply Higher Budget Deficts Threaten Perestroyka*, *op. cit.*, p. 5.
21 *Narkhoz za 70 let*, p. 485 and *Vestnik statistiki*, 3, 1988, p. 61.
22 *USSR: Sharply Higher Budget Deficits Threaten Perestroyka*, *op. cit.*, p. 7.
23 *Sotsiialisticheskaia Industriia*, April 6, 1989.
24 *Pravda*, January 22, 1989.
25 *The Economist*, June 17, 1989, p. 16.
26 *USSR: Sharply Higher Budget Deficits Threaten Perestroyka*, *op. cit.*, p. 7.
27 *The Economist*, June 17, 1989, p. 16.

The dramatic increase in investment demands should have been matched by planned increases in the production of investment goods, but supply did not rise apace. The time-honored presumption that excess demand in the Soviet economy arises exclusively in the consumer goods sector now needs to be reexamined.

While this expansion of investment demands has come from the financial allocations to enterprises from the budget, a fraction also results from the scramble by enterprises, under the new (if somewhat limited) flexibility, to seek profits by investing. Such activity is supported by credits from *Gosbank* which pave the way for inventory holdings and extra wage payments.

The traditional system of *kontrol' rublyom* (control by ruble) defined finance availability by centrally-assigned prices, wages, production and investments. It appears to have yielded in accommodating an incipient competition for investments by enterprises. This phenomenon has escaped general attention because, unlike bread lines, one does not see investors waiting for machine tools or diesel engines. Rather, excess demand takes the form of backed-up orders. Data on such backlogs of orders are routinely collected in most Western economies but are not yet available from Soviet sources.

Thus, the Soviet economy is in the midst of a transition in which repressed inflation through excess demand can now arise, not merely in consumer goods markets, but even for investment. Enterprise demands for investment goods, less rigidly controlled than before, can now exceed their supply. The more enterprises are freed to pursue profits by competing for investment goods (and in other "capitalist" ways), the freer the economy will be to enjoy the microeconomic fruits of flexibility. But, in the process, it will also face the consequences capitalist nations struggle to contain with tools of discretionary monetary, fiscal and incomes policies.

Policy Measures

What is then to be done to rescue a microeconomic program of price flexibility from this macroeconomic straitjacket in which it is imprisoned? The solution must have three parts: curtailing the budget deficit, activating monetary policy, and addressing the ruble overhang.

Reducing the Budget Deficit

Consider outlays first.

Defense: An obvious candidate for direct reduction of outlays is defense spending. Such a cutback reduces the deficit directly, and lowers it indirectly by leading to a shift in production from defense to consumer goods, thereby raising revenues from turnover taxes. These taxes are heavily concentrated on consumer goods.

Gorbachev has already announced his intention to reduce defense spending in 1989 and 1990 altogether by fourteen percent, and military hardware by nineteen percent. If these figures relate to his newly-disclosed (fourfold-higher) defense spending figures, then indeed he is promising himself a truly substantial cut in the budget outlays. But even if the figures relate to the lower traditional numbers, the intended cuts are not negligible. They will contribute siginificantly to the solution of the problem of inadequate voluntary savings in the economy.

Investment: Like reduced defense outlays, a rollback in investment would directly lower the budget deficit, divert resources to the production of consumer goods and indirectly ease the budget deficit via larger turnover tax revenues from the increased production of consumer goods. But while lowering defense outlays yields a permanent gain, lowering investment reduces future growth potential. If the planners were to postpone the proposed Tiumen petrochemical complex in Western Siberia and instead divert the resources to set up shoe, soap and textile factories, the switch would raise current consumption and raise government revenues from taxes on these items but reduce the economy's future potential for expanding these very same industries — petrochemicals are an important raw material for soap, shoes and textiles. By contrast, a permanent shift of existing defense capacities to the production of consumer durables would not cut the economy's future growth prospects.

The die is cast also with regard to investment spending in the Soviet budget. It will be cut by 7.5 billion rubles in 1989 and by at least eight billion rubles in 1990 [28] — the first such cuts in Soviet postwar history. [29]

Consumer Subsidies: Gorbachev has no plans to cut consumer subsidies. In fact, subsidies on food items are slated to increase in 1989, reaching nineteen percent of the budget. At first blush, this is not sensible. But there is an arguable rationale. If a large enough dent can be made in the deficit through major cuts in defense and minor cuts in investment, and through increased revenues, then it is unwise to cut subsidies on key consumer goods such as meat, bread and milk. These cuts would imply increased prices to consumers and such "taxation" would be regressive aside from being politically unpopular. The political upheavals in Third World countries that often attend the implementation of IMF austerity measures cannot have escaped Gorbachev's attention. Besides, in his overall strategy of Soviet reform, the main battalions against his opponents are the Soviet people.[30] Alienating them would not fit into his game plan. Gorbachev is thus wise to avoid cutting the subsidies, at least for now.

28 *Izvestiia*, March 30, 1989.
29 *The Soviet Economy in 1988: Gorbachev Changes Course*, *op. cit.*, p. 14.
30 *Cf.* Desai, *Perestroika*, *op. cit.*, Chapters 4-6.

Next, the budget revenues.

Importing Consumer Goods: The import of consumer goods results in revenues from the taxes levied on their sale. In addition, if any imports are credit-financed, they have a yet greater beneficial effect on excess spending: they increase total goods availability without adding to overall income and hence expenditure. Soviet planners have already announced credit-financed imports of a large variety of consumer goods from razor blades to detergent, raising the planned share of such imports in the 1989 import bill to ten percent. The domestic production of these items, by contrast, would result in additional wage payments which would add to the current pressures to consume more.

Producing Consumer Goods: Shifting production from other goods to consumer goods also helps. It will result in more revenue from turnover taxes. But it cannot have the added beneficial effect that credit-financed imports can have on the problem of excess demand. For, in a situation of full employment, if consumer goods increase in supply, other goods must correspondingly diminish in supply. The reduction in excess demand in consumer goods markets would then be matched by increase in excess demand in markets for other goods.

Activating Monetary Policy

The diminished control over enterprise wages, production and investments also requires that Soviet authorities now learn to use monetary policy to regulate the demand for investment goods and the working capital required for inventories and wage payments.

Gosbank can no longer advance funds to enterprises as in the past, when they were provided almost routinely to lubricate enterprise activity. Now, with greater enterprise freedom in the works, such an "accommodating" monetary policy could have serious inflationary consequences. The intention of the Law on State Enterprises is to encourage enterprises to economize on labor and material costs and make profits. This goal cannot be realized if enterprises continue getting funds virtually cost-free from *Gosbank* and use them for excessive wage payments and material stockpiles. The announcement by the Finance Minister that loans for financing inventories will now be subjected to a fifteen percent interest charge is a step in the right direction. [31]

Soviet banking in general needs to be organized along commercial principles. In the new arrangements already in place, the banks (like all state units) have been put under the rule of full cost-accounting. They should also be allowed to earn a reasonable rate of return on their loan operations. Another issue here is the need for an effective instrument for curbing enterprise borrowing. In the traditional practice of *kontrol' rublyom*, a local official of a *Gosbank* branch would more often than not approve the request for funds because he could be held responsible if the output plan of the enterprise failed due to shortage of funds. Now, he must be able to regulate borrowing by using the interest rate, varied by *Gosbank* authorities.

Solving the Ruble Overhang

These measures will address the problem of excess spending, and the repressed inflation associated with it, currently plaguing the Soviet economy. The substantial ruble overhang also needs to be contained to avoid massive dishoarding and consequent inflationary pressures when prices are let loose. But how?

Higher interest rates would help by converting some of the involuntary saving into voluntary saving. The promise of increased consumer durables in the foreseeable future — through schemes such as signing on for cars and other durables for future delivery with current down-payments — is another possibility.

A splendid opportunity for soaking up the Soviet public's excess liquidity also lies in the possibility of letting Soviet citizens buy the apartments they currently rent from the state. Housing is the most substantial of the assets which the state has come to acquire in the Soviet economy, going well beyond the Marxist ideology that the means of production should be owned by the state. In the process, the state has intensified official interference in people's lives, taking over the burden of managing housing properties. If the state cannot run factories properly, it cannot have any special aptitude for managing housing. The plans to privatize housing will thus not merely make a big dent on the ruble overhang, but should also create more efficient management and maintenance of the stock of housing. According to a recent decree, residents of apartments can buy them by paying half their price, with the balance payable over ten years.

On to Price Reform

Perestroika can proceed with price reform only after these steps have been successfully taken to defang the current macroeconomic dangers. How this reform should be designed is a complex and challenging issue of its own.

In the view of some specialists, prices should be freed in one fell swoop. Indeed, even total restoration of freedom to produce, invest and set prices and wages, as in classroom capitalist regimes, has been recently advocated for some centrally planned economies by active participants in the burgeoning "reform-mongering" business.

31 *Izvestiia*, March 30, 1988.

But there seems to be greater political wisdom, and good economic sense, in proceeding slowly. A sensible sequencing of sectors for freeing prices and investments would be to start with consumer goods. In the majority of these industries, the scale and hence financing requirements are such as to facilitate start-ups under a variety of arrangements including partnerships, cooperative arrangements, leasing of public investments, and joint venture agreements. The economic returns in these industries make entry attractive, as well. Production would thus increase and competition would be keen, leading to efficiency and responsiveness to market demands.

While permitting this large set of consumer goods to operate with freedom of pricing and entry, it would also be necessary to free up the allocations of raw materials and capital goods to these industries. Thus, steel would have to be available for steel playground slides, furniture and bicycles. But, instead of freeing up steel prices altogether, only a specified portion of steel production could be set aside, to be competed for at market-determined prices by these consumer goods industries. The remaining steel would go at fixed prices to other sectors not yet subjected to price reform.

Once the flexible price system is seen to function well in the "easier," competition-prone consumer goods industries, it can be extended to the larger, more complex and capital-intensive industries in the investment and raw materials sectors.

The aim of price reform and its appropriate pace and sequencing is to generate the gains of microeconomic efficiency in Soviet enterprises by providing them with market signals. For the present, however, the urgent task is to restore the macroeconomic health of the economy.

Most Soviet planners and economists, among them Abalkin, Aganbegyan and Shmelov, while arguing for price reform, have acknowledged the need for going slow on that front. So has the leadership, and correctly so.

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